IN THE

Supreme Court of the United States

No. 197.

Petitioner

vs.

Respondent

IN PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 197.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ANNA VICKERS CRAWFORD,

Respondent.

BRIEF FOR RESPONDENT.

I.

The Opinions of the Courts Below.

The memorandum opinion of the Tax Court [R. 103-112] is unreported. The opinion of the Circuit Court of Appeals [R. 131-134] is reported in 148 Fed. (2d) 776.

II.

Jurisdiction.

Jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

The judgment of the Circuit Court of Appeals was entered April 21, 1945. [R. 133.]

III.

Statement of the Case.

The facts in this case were stipulated by the parties and the Tax Court found the facts as stipulated. [R. 26-100, 103.]

The taxpayer owned an undivided one-third interest in the fee title to certain real property situate in the County of Los Angeles, California. [R. 27, 104.] On April 12, 1924 taxpayer, together with the owners of the remaining interests in the property, executed a lease with the Standard Oil Company, a California corporation, as lessee, for the drilling of oil on a portion of the property. [R. 27, 104.] The lessee was granted "the sole and exclusive right to drill for, produce, extract and take oil, gas, asphaltum and other hydrocarbon substances" from the property. [R. 33.]. The exclusive drilling and operating rights were granted for two years and for so long thereafter as the lessee should conduct drilling operations and so long as oil and gas were produced in paying quantities. [R. 33, 104.]

The lessee paid a bonus of $75,000.00 at the time of the execution of the lease [R. 33-34, 104], and agreed in paragraph 31 A of the lease to pay a minimum royalty of one-fifth of the sale value of all oil, asphaltum and other hydrocarbon substances extracted and saved from the premises and one-fifth of the actual proceeds of all gas produced and saved and sold off the premises. [R. 45.] In addition, pursuant to paragraph 31 B of the lease, the lessee agreed to pay such sum as shall represent the amount

by which one-half of the "net profits" derived from operations on said property shall exceed the aggregate of all royalties theretofore paid plus the bonus paid by the lessee. [R. 45.] The term "net profits" is defined by the lease to mean the amount by which the "gross proceeds" as therein defined exceeded the "chargeable expenses" as therein defined. [R. 43-44.] If the lessee failed for ninety days after written notice to comply with any provisions of the lease, the lessors had the right to terminate the lease, except that default as to any well or wells would not affect the lessee's operation of any other well or wells situated in any other ten acre parcel. [R. 46, 107.]

On January 6, 1925 the lessors entered into another lease with the same lessee for the drilling of oil on a different portion of the property. The lease was for a term of five years and so long thereafter as oil and gas were produced in paying quantities unless the land had otherwise been surrendered or forfeited by the lessee. [R. 52; 107.] The provisions of this lease were substantially the same as those of the first lease between the same parties [R. 49-64; 107] except that the bonus was $80,000 [R. 52-53; 107] and the minimum monthly sum to be paid was one-sixth of the "sale value" of the oil, asphaltum and other hydrocarbon substances extracted and one-sixth of the actual proceeds of the gas produced, saved and sold off the premises. [R. 63, 107.] The provisions for the payment of one-half of certain "net profits" were the same as the provisions of paragraph 31B of the prior lease. [R 63, 107.]

On April 18, 1924, the lessors executed another lease with the Associated Oil Company, a California corporation, for the drilling of oil on another portion of the same property. The property covered 101 acres, more or less, and was leased for a term of twenty years. [R. 66-69; 107-108.]

The lease provided for a "primary royalty" of one-sixth of the oil and gas produced [R. 80, 108], and for a "secondary royalty" in an amount equal to one-half of the difference between certain specified "Operating Charges" and certain specified "Income Credits". [R. 83-84.]

The lease contained provisions for surrender by the lessee, or for termination by the lessors in the event that the lessee failed to comply with the provisions of the agreement. [R. 91-93; 109.]

During the taxable years in question all three leases were in effect. During the years 1938, 1939, and 1940, taxpayer received, pursuant to paragraph 31A of the Standard Oil leases, gross income from primary royalties in the aggregate respective amounts of: $50,321.41, $45,771.09, and $39,534.63; during the same years taxpayer received pursuant to paragraph 31B of these leases the following respective amounts: $62,327.91, $52,693.39, and $44,506.39. [R. 28-29; 109-110.]

During the same years taxpayer received primary royalties from Associated Oil Company, pursuant to paragraph 22 of that lease, in the respective amounts of $19,700.03, $20,275, and $20,958.88; during the same years she received secondary royalties pursuant to paragraph 23 of

the lease, in the respective amounts of $34,729.20, $34,883.54 and $39,941.02. [R. 29; 110.]

In computing her taxable income for the years in question, taxpayer deducted statutory depletion at the rate of 27½ per cent of the respective amounts set forth above. The Commissioner determined deficiencies for income taxes for the years in question resulting in primary part from his determination that taxpayer was not entitled to deduct depletion on the additional or secondary royalties paid pursuant to paragraphs 31B of the Standard Oil leases and paragraph 23 of the Associated Oil Company lease. [R. 29-30; 103.]

The taxpayer sought a redetermination of the deficiencies before the Tax Court. The Tax Court refused to uphold the Commissioner's determinations in this respect, ruling that the taxpayer was entitled to a deduction for statutory depletion on all amounts received by her pursuant to the above mentioned leases. [R. 103-112.] The Circuit Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision. [R. 131-134.]

IV.

Statutes Involved.

Internal Revenue Code:

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable

allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *
(26 U. S. C. 1940 ed., Sec. 23.)

Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(b) *Basis for Depletion.*—

* * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under Section 23(a) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23(m) be less than it would be if computed without reference to this paragraph.

* * *

(26 U. S. C. 1940 ed., Sec. 114.)

V.

ARGUMENT.

Summary of the Argument.

I. By the execution of the oil and gas leases involved, the taxpayer, as fee owner with full reversionary rights, necessarily retained an economic interest in the oil in place. Consequently all payments received by her from the lessees, including cash bonuses, basic royalties and additional or supplementary royalties measured by a portion of certain net profits derived by the lessees from the production and sale of oil, constitute "gross income from the property" subject to statutory depletion. The leases cannot be deemed to have effected a sale by the taxpayer of any portion of her economic interest in the oil in place.

II. On the basis of the rule of the *Dobson* case, the decision of the Tax Court should be affirmed.

III. In the alternative, if the net profit participation in the results of the lessees' production and sale of oil and gas are not royalties subject to depletion, they must be treated as capital gain.

I.

The Taxpayer as Fee Owner Is Entitled to Statutory Depletion on All Proceeds Received From Her Lessees.

Section 23(m) of the Revenue Act of 1938, and of the Internal Revenue Code provides for a deduction from gross income of a reasonable allowance for depletion in the case of oil and gas wells. Section 114(b)(3) of the Revenue Act of 1938, and of the Internal Revenue Code states that this allowance for depletion shall be 27½ percent "of the gross income from the property during the taxable year." The sole issue in the instant case is what was the taxpayer's gross income from the property during the years 1938, 1939 and 1940.

The taxpayer, respondent herein, contends that as fee owner of land containing oil deposits every dollar received from her lessees constitutes gross income from the property subject to statutory depletion regardless of the method of determining the amount of dollars payable. The fee owner of land subject to an oil and gas lease necessarily has an economic interest in the oil in place because of ownership of the land. Every barrel of oil taken from the land depletes the fee owner's interest in the oil in place and every dollar paid to the fee owner by the lessee in consideration of the extraction and marketing of the oil constitutes recompense to the fee owner for the depletion of the oil in place. Accordingly, all moneys paid to the taxpayer by her lessees constitute "gross income from the property" subject to depletion.

The Commissioner of Internal Revenue has conceded that taxpayer is entitled to depletion on the cash bonuses and basic royalties provided for in the leases involved, but

has denied depletion on the additional or supplementary royalties provided for in the same leases. This position of the Commissioner cannot be supported by the decisions of this Court. It is artificial, illogical and indefensible both as matters of law and economics.

A. THE OWNERSHIP OF AN ECONOMIC INTEREST IN THE OIL IN PLACE DETERMINES THE RIGHT TO DEPLETION.

The ownership of an economic interest in the oil in place is the touchstone to the right to depletion. *Palmer v. Bender*, 287 U. S. 551; *Thomas v. Perkins*, 301 U. S. 655; *Anderson v. Helvering*, 310 U. S. 404.[1] This economic ownership of the oil in place represents the taxpayer's capital interest or investment in a wasting asset, and to the extent oil is extracted, the taxpayer's capital has suffered depletion. Payments of money to the owner of an economic interest in the oil in place on account of the oil extracted are subject to allowances for statutory depletion. *Helvering v. Mountain Producers Corp.*, 303 U. S. 376; *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312.

As to these basic principles, there appears to be no dispute. However, the Commissioner takes the position that in order to determine whether the taxpayer possesses an economic interest in the oil in place, it is necessary to look solely to the method of payment by the lessee or working interest. He then seeks to establish the rule that to the extent there is a participation in the net profits of the work-

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[1]See 4 Mertens, Law of Federal Income Taxation (1942 Ed.) Sec. 34.21; *Depletion Allowances in Taxation of Income Derived from Oil Royalties and Oil Payments*, 47 Yale Law Journal 806 (1938).

ing interest, there can be no economic interest in the oil in place.[2]

The taxpayer believes that in order to determine whether there is ownership of an economic interest in the oil in place, the method of payment by the working interest may be an important factor in certain instances, but it is not the sole determinative factor. Consideration must also be given to the ownership of the real property containing the oil deposit and to the substantive nature of the legal document creating the rights between the parties. The many decisions of this Court in connection with the depletion of oil royalties hold that in the case of an oil and gas lease, the fee owner-lessor always retains an economic interest in the oil in place,[3] whereas in the case of an agreement made by the fee owner which constitutes a sale, an economic interest may or may not have been retained dependent upon the nature of the method of payment by the working interest,[4] and the source of the payments.[5]

B. Net Profit Participation in Results of Drilling May Constitute a Royalty Subject to Depletion.

The Commissioner has contended that participation in the net profits of the working interest can never constitute a royalty subject to depletion. To support this position, the Commissioner relies upon various statements

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[2] See General Counsel Memorandum 22730, 1941-1 C. B. 214.

[3] See *e. g. Burnet v. Harmel*, 287 U. S. 103; *Murphy Oil Co. v. Burnet*, 287 U. S. 299; *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459; *Herring v. Commissioner*, 293 U. S. 322.

[4] *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372.

[5] *Anderson v. Helvering, supra.*

made by this court in its decisions in *Helvering v. Bankline Oil Co.*, 303 U. S. 362; *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372, and *Anderson v. Helvering, supra*. Divorcing these statements from their context and the facts of the particular cases involved, the Commissioner has formulated a principle that is logically and economically indefensible.

In the first place, these four cases do not support the Commissioner's position either as a matter of fact or law. The *Bankline* case did not involve the element of a net profit participation, but the question whether or not the contractual right to extract wet gas at the mouth of a well represented an economic interest in the oil in place. This Court held that it did not, stating "a mere economic advantage derived from production, through a contractual relation to the owner" does not represent an economic interest.

The *O'Donnell* and *Elbe Oil Land Development Co.* cases did involve the element of net profits. There is nothing in these cases, however, which requires or even supports the Commissioner's contentions.

In the *O'Donnell* case the facts were as follows:

The taxpayer owned one-third of the capital stock of the San Gabriel Petroleum Company. He sold this stock to the Petroleum Midway Company, Limited, and as consideration the Midway Company agreed to pay him one-third of the net profits from the development and operation of the oil and gas properties acquired by the Midway Company. The Midway Company acquired the properties of the San Gabriel Petroleum Company, operated them, and one-third of the net profits were paid to the

taxpayer who took depletion against such payments for the years 1925 and 1926.

This Court held that the taxpayer was not entitled to depletion, stating:

> "The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place. (Citations omitted.) As a mere owner of shares in the San Gabriel Company, respondent had no such interest. Treasury Regulations No. 69, art. 201. The ownership of the oil and gas properties was in the corporation. When the Midway Company acquired these properties from the San Gabriel Company and operated them, the Midway Company became the owner of the oil and gas produced. It was the owner of the gross proceeds or income upon which the statutory allowance for depletion was to be computed. *Helvering v. Twin Bell Syndicate, supra.* The agreement to pay respondent one-third of the net profits derived from the development and operation of the properties was a personal covenant and did not purport to grant respondent an interest in the properties themselves. If there was no net profits, nothing would be payable to him. No trust was declared by which respondent could claim an equitable interest in the *res.* As consideration for the sale of his stock in the San Gabriel Company, respondent bargained for and obtained an economic advantage from the Midway Company's operations but that advantage or profit did not constitute a depletable interest in the oil and gas in place. *Palmer v. Bender, supra; Helvering v. Bankline Oil Company, supra.*"

The basis of this decision is self-evident. The taxpayer did not own an economic interest in the oil in place by virtue of his stock ownership in the corporation holding the oil properties; the sale of his stock could not operate

to convert his stock interest into an economic interest in the oil in place merely because the purchaser agreed to pay a percentage of the net profits derived from the operation of the well. The result in this case would have been the same had O'Donnell received a gross interest in the oil produced.[6]

In the *Elbe Oil Land Development Co.* case, the taxpayer was the owner of certain oil and gas prospecting permits, drilling agreements, leases and equipment. Development work resulted in the discovery of oil and the taxpayer thereafter conveyed all its right, title and interest in and to the said properties to the Honolulu Consolidated Oil Company. The Oil Company agreed to pay the taxpayer $350,000.00 upon the execution of the agreement, and if it should not elect to abandon the purchase, an additional $1,650,000.00 during the years 1928 to 1931. After the company had been fully reimbursed as provided in the agreement for all its expenditures in the acquisition, development and operation of the properties, taxpayer was to receive monthly one-third of the net profits resulting from the production and operation.

The agreement specifically provided that it was the intention of the parties that "the full ownership, possession and control of all of the properties, the subject of this agreement, and of all of the personal property acquired, and/or used on and in connection with the operation and development of the properties, the subject of this agreement, shall be vested in Honolulu, and Elbe shall have no interest in or to said properties * * *."

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[6] *Haynes v. U. S.*, 50 F. Supp. 238 (Ct. Claims, 1943).

The taxpayer treated the down payment of $350,000.00 as capital gain, and during 1928 and 1929, claimed depletion on the payments of $400,000.00 each year received by it.

This Court held that the taxpayer was not entitled to depletion, saying in material part:

> "We agree with the conclusion of the Board of Tax Appeals that the contract between the respondent and the Honolulu Company *provided for an absolute sale of all the properties in question,* including all the oil and gas in place, and that respondent did not retain any interest or investment therein. The aggregate sum of $2,000,000.00 was paid as an agreed purchase price to which was to be added the one-third of the net profits payable on the conditions specified. We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction *as an absolute sale or was other than a personal covenant of the Honolulu Company.* See *Helvering v. O'Donnell,* 303 U. S. 370, 58 S. Ct. 619, decided this day." (Emphasis added.)

It appears clear that neither of these two cases supports the rule which the Commissioner is attempting to establish. In the *O'Donnell* case, the taxpayer never had an economic interest in the oil in place. In the *Elbe* case, the taxpayer had an economic interest in the oil in place, but through an absolute and unqualified sale divested itself of such interest. The taxpayer in the *Elbe* case had sold his interest beyond recall or reversion, had received part of the purchase price and been taxed on it as capital gain and then claimed depletion on the balance. All it had left was a right to share in net profits payable if the purchaser first recovered all his costs including the purchase price of the properties. Such right was held not to be an economic interest in the oil in place.

In *Anderson v. Helvering, supra*, the facts were that the Oklahoma City Oil Company owned certain royalty interests, fee interests, and deferred oil payments in properties in Oklahoma. In 1931 the Company entered into a written contract with the taxpayer providing for the conveyance to him of these interests for the agreed consideration of $160,000.00 payable $50,000.00 in cash and $110,000.00 from one-half of the proceeds received by him from oil and gas produced from the properties and from the sale of fee title to any or all of the land conveyed. Interest at the rate of 6 percent per annum was to be paid from the proceeds of production and of sales upon the unpaid balance of the purchase price. The Company was to have a first lien as security. The taxpayer turned over one-half of the gross proceeds during 1932 to the Company, and the question for decision was whether the one-half of the proceeds paid over to the Company should be included in the gross income of the taxpayer for the year 1932.

This Court held that the Company did not retain any economic interest in the oil in place because of the fact that not only was there a sale of the entire interest, but the Oklahoma Company was not dependent entirely upon the production of oil for the deferred payments. Such payments might be derived from sales of the fee title by the taxpayer.

This case is clearly distinguishable. Not only did the *Anderson* case involve an outright sale, but there the Company was not, as here the taxpayer is, entirely dependent upon production of oil to receive the payments called for. Also in the *Anderson* case, there were (1) no reversionary rights in the Company, and (2) no security for the payments. Here the taxpayer has full reversionary

rights and the lessees' agreement to pay royalties, both gross and net profits, are secured by the oil in place.

The four cases above discussed cannot be said to support the rule the Commissioner is trying to establish; on the contrary these cases establish the following rules:

(1) The acquisition of a contractual right to extract wet gas at the mouth of a well is not an economic interest in the oil in place;

(2) If the right to share in the net profits of the working interest is a mere personal covenant, such right does not, of itself, confer an economic interest in the oil in place;

(3) The complete sale of an economic interest reserving only a right to share in the net profits of the oil producer, does not result in the retention of an economic interest in the oil in place; and

(4) The sale of an economic interest reserving an oil payment does not result in the retention of an economic interest if the working interest may make the oil payment from sources other than the oil and gas produced.

Clearly these cases do not hold that a right to share in net profits of oil production can never constitute an economic interest in the oil in place. Furthermore, the taxpayer can perceive no compelling reason for the promulgation of such a rule. It is clear that in the oil industry a "royalty" may encompass "net profits."[7]

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[7]"Occasionally leases provide for a royalty on oil in the form of a share of the net proceeds of production and sale." 3 *Summer, Law of Oil and Gas* (1938 ed.), Sec. 5.71. "A royalty can consist of a percentage of net profits. 2 *Thornton*, Oil and Gas (Willis, 5th ed. 1932), Sec. 363.

That the parties to the leases involved intended the net profits feature to represent additional royalty is obvious; the Associated Oil Company lease refers to the gross proceeds royalty as "a primary royalty", and the extra payments as "secondary royalty". Also, in defining the secondary royalty, no mention is made of net profits but the lease merely provides that a secondary royalty shall become payable and shall be ascertainable according to specifications therein set forth which first list operating charges or deductions and next specify income credits, and one-half of the difference between the income credits and operating charges is classified as the secondary or additional royalty.

It is clear that in none of the leases involved does the taxpayer participate in the net profits of the lessee in accordance with the usual understanding of the term "net profits". Rather the participation is limited to certain net proceeds derived from operation without regard to deduction of interest and other such expenses of the lessee. It is the same as if the parties had agreed to divide gross proceeds after sharing proportionately in operating expenses.

Had the parties provided for an additional royalty measured by the gross proceeds of the lessee over and above a fixed sum, or a lump sum payment after production had attained a certain level, such gross proceeds or lump sum paid to lessor would have been depletable. The mere fact that the parties selected a particular type of net profits as their yardstick for determining the amount of additional royalties should not change the nature or extent of the taxpayer's economic interest in the oil in place.

Because of the use of "net profits" as a yardstick, the Commissioner labels the secondary royalties as personal

covenants. This conclusion wantonly disregards basic principles of law. The secondary or additional royalties in the taxpayer's leases are not mere personal covenants. They are covenants running with the land, binding the successors in interest of the parties by privity of estate.[8]

No case decided by this Court or the United States Tax Court (formerly Board of Tax Appeals) has ever denied depletion to a fee owner-lessor. On the contrary, with the exception of the decision of the Fifth Circuit Court in the *Kirby* case,[9] every recorded decision has unanimously held that the fee owner upon the execution of an oil lease retaining full reversionary rights in the land and oil, necessarily retains an economic interest in the oil in place and is therefore entitled to depletion on all payments received from the lessee.[10] Thus, even if there were no basic or gross proceeds royalty, the fee owner-lessor should be entitled to depletion.

The Commissioner's argument appears to be bottomed on a syllogistic conclusion drawn from *Helvering v. Elbe Oil Land Development Co., supra,* as a major premise, and *Palmer v. Bender, supra,* as a minor premise. The *Elbe* case held that in an outright sale by the owner of an economic interest in oil, the right to receive a percentage of the vendee's net profits does not constitute the reten-

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[8]Calif. Civil Code, §§ 1460-1464; *Standard Oil Co. v. Slye,* 164 Cal. 435, 129 Pac. 589 (1913); *Richardson v. Callahan,* 213 Cal. 683, 3 Pac. (2d) 927 (1931); *Washburn v. A. F. Gilmore Co.,* 116 Cal. App. 370, 2 Pac. (2d) 506 (1931).

[9]148 Fed. (2d) 80 (1945).

[10]See cases cited in note 3, *supra;* also *Commissioner v. Felix Oil Co.,* 144 Fed. (2d) 276 (C. C. A. 9th, 1944); *Marrs McLean v. Commissioner,* 41 B. T. A. 565, 574 (Gray Lease) affirmed 120 Fed. (2d) 942 (C. C. A. 5th, 1941); Cert. den. 314 U. S. 670 (1941); rehearing den. 314 U. S. 713; *Kirby Petroleum Co. v. Commissioner,* 2 T. C. 1258; *Palmer v. Bender, supra; Burnet v. Harmel, supra; Cf. Anderson v. Helvering, supra.*

tion of an economic interest in the oil in place. *Palmer v. Bender* held that the mere form of a legal instrument does not determine the existence of an economic interest. The Commissioner concludes that whether the parties execute a lease or make a sale is immaterial; the participation in the net profits destroys the economic interest in the oil in place.

Like most syllogistic conclusions, this one contains an inherent fallacy. What the Commissioner has failed to cognize is that in the cases wherein it was decided that the formalities of conveyancer's art are immaterial, the question involved was whether an assignment of a lease which technically operated as a sale of the lessee's interest, should be governed by the legal consequences of the form of the instrument in determining whether royalties in kind should be treated as ordinary income subject to depletion or capital gain.[11]

This Court has never held or even intimated that it is immaterial whether the fee owner sells his land or leases it. On the contrary, as cogently stressed in the *Elbe* and *Anderson* cases, the taxpayers there had made absolute sales of their interests. It was the fact of the absolute sale which made the agreement of the purchaser to pay a portion of net profits a personal covenant.

All of the cases herein cited compel the conclusion that an oil document entered into between the fee owner and the person who is to extract and sell the oil, must, in substance be considered either a lease or a sale. They hold that if the former, there is a retention of an economic interest of the oil in place; if the latter, there may not be.

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[11] *Cf. Burnet v. Harmel, supra.* Technical passage of title to the oil in place according to State law is not determinative.

depending upon the nature of the payments to be made. The Commissioner in the instant case is making the stultifying argument that in one and the same document, which is a typical oil and gas lease, the taxpayer has sold a part of her economic interest in the oil in place and retained a part.

The leases involved do not purport to be anything other than the usual form of an oil lease. The taxpayer, as fee owner, retained all rights of ownership except those specifically granted to the lessee, to-wit: the sole right to explore for, discover and produce oil and gas, and such incidental rights as were necessary for this purpose. Should the lessee not drill, or stop drilling, or fail to pay royalties or default in any of its covenants, the land and oil revert to the lessor.

Technically, under California law, these oil leases do not constitute a sale by the owner of the oil in place, and ownership of the oil and gas does not pass to the lessee until after severance.[12] Likewise, as a matter of substance or consequence for purposes of Federal income taxation without regard to the niceties of state law as to passage of title to oil deposits, these leases cannot be considered as a sale by the taxpayer of any portion of her interest in the oil in place. The words "net profits" in the leases involved cannot have the magic power to convert a simple lease into a partial sale.

The weakness of the Commissioner's position is highlighted by the fact that under certain circumstances it would result in no one being entitled to depletion.

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[12]The fee remains in the lessor; the lessee acquires only a *profit a prendre* to take the oil. *Callaghan v. Martin*, 3 Cal. (2d) 110; *Spalding v. United States*, 17 Fed. Supp. 957 (1937).

It is clear that every barrel of oil taken from the ground depletes someone's economic interest, and someone is entitled to depletion. It is also clear that only a single allowance for depletion may be taken on each barrel of oil extracted and that this allowance must be apportioned between the persons entitled to share in such oil in proportion to their respective interests. *Helvering v. Twin Bell Oil Syndicate, supra.*

The following hypothetical case clearly demonstrates the indefensibility of the Commissioner's argument. Assume that the taxpayer in the instant case had herself drilled and brought in an oil and gas well on her own land. Thereafter she entered into a contract for a period of years with the X Corporation whereby the taxpayer agreed to deliver the wet gas to X through pipe lines at the casing head or trap at the mouth of the well to X's plant where X would extract the gasoline from the wet gas, sell it and pay the taxpayer 33 percent of the gross proceeds received. These assumed facts parallel those of *Helvering v. Bankline Oil Co., supra.* Under the *Bankline* case X would not be entitled to depletion, but the taxpayer would. Assume further that the contract provided that X Corporation would pay the taxpayer 50 percent of its net profits from operations instead of 33 percent of the gross. X would not be entitled to depletion because it does not have an economic interest in the oil in place. According to the Commissioner's argument, neither would the taxpayer be entitled to depletion because she is entitled to receive only the net profits from operation. As the Commissioner would have it, all of the gas in place could be extracted and sold and nobody would be entitled to depletion. The mere statement of this possibility reveals the falsity of the Commissioner's position.

The Commissioner's argument places too much weight upon mere labels. As above shown, the source of the payment made to the landowner cannot always be controlling. The situation is analogous to depletion of cash bonus payments made in advance of drilling. The rule is firmly established that a lessor or sublessor who receives a cash bonus and reserves a royalty interest is entitled to depletion on both. See *e. g., Herring v. Commissioner, supra.* The gross proceeds royalty interest retained represents an economic interest in the oil in place. The cash payment normally made in advance of drilling is deemed to be in partial depletion of the oil reserves and the owner of the royalty interest is entitled to depletion thereon. The payment of a percentage of net profits is analogous to the payment of a bonus in that it is recompense to the land owner for the extraction of oil taken out. The mere fact that the cash bonus is usually limited in amount and paid in advance is immaterial. If the lessee should agree to pay a cash bonus, say of $50,000.00, after a certain number of barrels of oil had been extracted, or after the lessee had received net profits from production equal to a specific amount, it can hardly be contended that no depletion would be allowable on the bonus merely because it is contingent in time and in amount. The controlling factor appears to be that the taxpayer by the execution of the leases reserving a basic royalty interest and retaining full reversionary rights, has not sold any portion of her interest in the oil in place, and all payments received from the lessees are on account of depletion of the taxpayer's interest by production.[13]

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[13]See *Appleman, Taxation of Net Profits from Oil and Gas Properties* (June, 1945), Texas Law Review.

II.

The Decision of the Tax Court Should be Affirmed on the Basis of the Rule of the Dobson Case.

In *Dobson v. Commissioner*, 320 U. S. 489, this Court enunciated the principle that Tax Court decisions have finality "when the Court cannot separate the elements of a decision so as to identify a clear-cut mistake of law * * *."

On questions of fact, the judicial function of the reviewing court is only to determine whether there is warrant in the record and a rational basis for the conclusions of the tax Court.[14]

The sole question involved in the instant case is what was the taxpayer's "gross income from the property." The Tax Court determined that the amounts paid by the lessees to the taxpayer as secondary or additional royalties pursuant to the leases involved constituted gross income to the taxpayer from the property.

The concurring opinion of Mr. Justice Frankfurter in *Trust u/w of Mary Lily (Flagler) Bingham, et al. v. Commissioner, supra*, indicates that the instant case particularly calls for the application of the *Dobson* rule.

The question of what was the taxpayer's gross income from the property during the taxable year is a question bordering on the province of accounting. It calls for "the specialized equipment of the Tax Court and the trained instinct which comes from its experience * * *."

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[14] *W. G. Choate v. Commissioner*, 324 U. S. 1; *Commissioner v. Court Holding Company*, 324 U. S. 331; *Mary Lily (Flagler) Bingham, et al. v. Commissioner*, 65 Sup. Ct. 1232.

This question does not involve any matter outside of the special province of the Tax Court, such as the "constitutional adjudication, determination of local tax questions and common law rules of property, such as the meaning of a 'general power of appointment' or the application of a rule against perpetuities * * *." On the contrary, this question has significance solely as a matter of income tax law. The Tax Court is aware of what really happened in the situation involved, "and what it means in the taxing world." The precise point in issue has been before the Tax Court time and again, always with the same result.[15] Under these circumstances, it can hardly be said that the decision of the Tax Court involved a "clear-cut mistake of law."

III.

If the Net Profit Participations Are Not Subject to Depletion, They Must be Treated as Capital Gain.

In the alternative, the taxpayer contends that if she is not entitled to depletion on the sums involved, they must be treated as capital gain.

In *Anderson v. Helvering, supra,* this Court said:

> "The sole owner and operator of oil properties clearly has a capital investment in the oil in place, if anyone has, and so is taxable on the gross proceeds of production and is granted a deduction from gross income as compensation for the consumption of his

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[15]See *Kirby Petroleum Co.*, 2 T. C. 1258; *Marrs McLean, supra,* Note 9; *Felix Oil Co.*, Memo. Op. Docket 107148; *W. S. Green*, 26 B. T. A. 1017.

capital. See *Burnet v. Harmel, supra*, 287 U. S. at pages 107, 108, 53 S. Ct. 75, 76, 77 L. Ed. 199; *Helvering v. Clifford*, 309 U. S. 331, 60 S. Ct. 554, 84 L. Ed. 788, No. 383, October Term, 1939. By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance. 'The words "gross income from the property," as used in the statute governing the allowance for depletion, means gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves.' *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372, 375, 376, 58 S. Ct. 621, 622, 82 L. Ed. 904."

The question therefore would appear to be, is the income derived by the taxpayer gross income from the oil property subject to depletion or income from the sale of the oil and gas properties themselves.

If the proceeds received by the taxpayer by virtue of the net profit participation provisions of the leases are not royalties, *i. e.*, ordinary income subject to depletion, it must be because the taxpayer has sold some portion of her economic interest in the oil in place. If she has sold or parted with some portion of her interest, the transaction must constitute a sale or exchange within the meaning of Section 112 of the Revenue Act of 1938, and of the Internal Revenue Code. This conclusion is ineluctable.

If the net profit participations of taxpayer were capital gain, the taxpayer's income tax liability for the years in-

volved would be substantially less than the amount of income tax liability reported and paid by the taxpayer.[16]

The instant case presents the inverse situation to that involved in *Helvering v. Elbe Oil Co., supra.* In the *Elbe* case, the taxpayer treated the bonus or initial payment of $350,000.00 as a capital gain. The taxpayer then claimed depletion on later payments made pursuant to the sales agreement. The taxpayer placed itself in the anomalous position of treating the transaction as a sale for a consideration taxable as capital gain plus a consideration on which depletion was claimed. In the instant case, the Commissioner, to be logically consistent, should contend that the payments on which it is claimed no depletion is allowable, should be treated by the taxpayer as capital gain. The Commissioner, however, has not carried the logical process this far and has merely denied depletion on the "net profit" participation without characterizing the nature of the moneys received by the taxpayer. The percentage of the net profits of the working interest received by the taxpayer is income, but income does not exist in a vacuum. Moneys received by a taxpayer, either are or are not income by virtue of the nature of the transaction producing the money. In the instant case, they are income either because (1) they are the consideration received by the fee owner for permission to extract oil from the fee owner's property, or (2) they are consideration for a sale by the fee owner of a portion of her interest in the oil in place.

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[16]

Year	Tax Actually Paid	Tax Payable on Basis of Capital Gains	Overpayment
1938	$43,343.37	$21,545.51	$21,797.86
1939	34,650.79	18,122.92	16,527.87
1940	50,026.87	27,449.94	22,576.93

If they fall under the first alternative, they would be gross income from the property subject to depletion; if they fall under the second alternative, they would constitute capital gain subject to special tax treatment. The Commissioner contends that they do not fall within the first alternative, but has failed to place them under the second alternative. In effect, by treating the net profits receipts as ordinary income, the Commissioner has recognized that no sale has taken place of taxpayer's interest, or any part thereof, in the oil in place. If the taxpayer has not sold any portion of her interest in the oil, she has the same capital investment in the oil deposits after the execution of the leases as she had before, and under these circumstances the taxpayer is required to resort to depletion for a return of her capital investment.

Conclusion.

The taxpayer, as owner of the fee, did not sell any portion of her economic interest in the oil in place and all amounts received by her from the three oil leases involved constitute gross income from the property subject to depletion. The decisions of the Tax Court and the Ninth Circuit Court of Appeals do not involve any clear-cut mistake of law and should be affirmed.

Respectfully submitted,

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